Legislative Department
Seattle City Council
Memorandum

Date: April 3, 2012

To: Library, Utilities and Center (LUC) Committee

From: Meg Moorehead, Council Central Staff

Subject: **Seattle Public Utilities (SPU) Financial Policy Statement of Legislative Intent (SLI) Response Follow-Up**

RELATIONSHIP BETWEEN FINANCIAL POLICIES AND RATES

The Council adopted financial policies for each of SPU's three funds: the Water Fund (WF), Drainage/Wastewater Fund (DWF) and Solid Waste Fund (SWF). SPU is required to submit rate proposals that meet the adopted financial policies, which may require SPU to collect more rate revenue than needed to cover expenses. The policies and revenue provide certainty that financial obligations can be met even if spending or revenues differ from forecasts, maintain strong credit ratings, help prevent abrupt year-to-year changes in rates, and contain the utility's long-term debt.

Financial policies are one of three main factors that can be changed to moderate rate increases:

- Financial policies: Policies can be changed to reduce the financial "cushion" included in rates to address planning uncertainties or to reduce the amount of cash used to finance capital projects.
- Expenditures: The amount collected through rates includes planned expenditures plus dollars needed to meet financial policies. Reduced spending on both operations and maintenance (O&M) and the capital improvement program (CIP) may reduce rates.
- Revenues: If financial policies remain the same and spending increases, rates must increase unless alternative revenue sources (such as grants or General Subfund dollars) are available.

Under current financial policies and rate proposal practices, SPU delivers rate proposals that meet financial policies and cover the cost of service levels proposed by SPU. Council then cuts or adds services using SPU's proposal as a base.

2012 BUDGET FINANCIAL POLICY SLI 13-1-A-1

SPU projected 2013 rate increases of 8% for wastewater, 16% for drainage and 9% for solid waste during Council review of the 2012 budget. The Council responded by approving SLI 13-1-A-1, which requested a review of SPU financial policies in advance of expected rate increase proposals. The SLI requested an explanation of why each financial policy was selected, a comparison of SPU financial policies and bond ratings to those of comparable utilities and City

Light, and an evaluation of DWF cash-to-CIP contributions of 25% (the current policy) compared to a 20% cash-to-CIP policy.

SPU's SLI response recommended keeping current financial policies to contain debt and retain strong bond ratings. The policies spread the cost of long-lived infrastructure among current and future ratepayers. They help ensure that revenues needed for day-to-day operations are not overly committed to debt repayment. And the City's willingness to maintain the financial policies in the face of rising rates has contributed to SPU's strong bond ratings and low borrowing costs. The rationale is consistent with Council's original intent in adopting the financial policies. Yet it has been several years since the policies were last revisited and circumstances in each Fund have changed, so that Council review of the policies is timely.

QUESTIONS AND POTENTIAL POLICY ISSUES

In its discussions of financial policies, the Committee has been interested in containing future rate increases while maintaining a solid financial position and providing reliable service. Central Staff and SPU working together to develop information to address the following questions and policy issues that address Committee interests:

<u>Possible Financial Policy Changes</u>

1) **Should simplification of financial policies be considered?** Many utilities with similar bond ratings have fewer financial policies. Adopting one dominant policy for each Fund might reduce revenue requirements in a given rate period because secondary policies would no longer be constraints. The policy might be debt-oriented (debt service coverage or debt-to-assets) for the capital-intensive DWF and WF, and operating revenue-oriented (net income or year-end cash) for the operation contracts-intensive SWF.

2) **Should policy compliance be measured over longer periods?** Compliance with the cash-to-CIP policy in the WF is measured over a rate period. The multiple year compliance schedule allows rate impacts to be evened out over years with higher or lower capital programs. The cash-to-CIP policy in the DWF is measured over a rolling four-year average. If other financial policies also were measured over multiple years, rate increases might be reduced in years when a certain policy causes a peak revenue need.

If financial policy changes are recommended, they may need to be phased in over more than one rate period and so may not significantly change rate proposals expected in 2012.

<u>Rate and Expense Containment</u>

3) **Should an additional rate containment policy be considered?** If rate increases are the primary concern, a rate containment policy could be adopted separate from the financial policies. Instead of SPU delivering rate proposals that reflect its own judgment about spending levels, the policy could identify Council expectations about the size of rate increases (such as no more than inflation plus 2%). Such a policy would need to consider how to address regulatory requirements, Council initiatives and other circumstances outside of SPU's control that may drive rate increases above targeted levels.

4) **Should rate proposals be considered less frequently?** Drainage, wastewater and solid waste rates generally are proposed in two-year cycles, allowing rates to be increased every two years to cover revenue shortfalls and new expenses. Water rates are set every three years. The Council could request rate proposals to be delivered on longer cycles (perhaps every three to four years). If lower revenues or higher expenses occur during the longer rate period, SPU would need to delay projects or reduce other expenses to live within its means until new rates are adopted.

NEXT STEPS

After SPU delivers information to help answer the above questions, a more thorough analysis of policy options will be developed for discussion at the April 17 LUC Committee meeting.